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C O R R E C T E D C O P Y (ADDED "CLASSIFED BY" LINE)

SIPDIS

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TAGS: EFIN ECON PGOV MO
SUBJECT: 2008 BUDGET'S DIFFICULT PASSAGE UNDERSCORES
GOVERNMENT TENSIONS

RABAT 00001810 001.2 OF 003

Classified by ECONOFF Stuart M. Smith for reasons 1.4 (b) and (d).

¶1. (SBU) Summary: Morocco's lower house approved the government's 2008 budget on Saturday, December 1, after a raucous debate that saw opposition deputies accuse the government of misusing its constitutional power to rule opposition amendments out of order. The budget's torturous passage through the lower house also underscored tensions in the government, as the socialist USFP abandoned its coalition partners and pressed for a cut in both the country's income tax and for maintenance of a higher profit tax rate on Morocco's banks. In the end, Finance Minister Salaheddine Mezouar was forced to compromise, agreeing to limit the reduced bank rate to 37 percent and to agree to consider lowering income tax rates starting in 2009. If the government's decision to wield its constitutional power to close of debate underscored the limits of parliament's power in Morocco's budgetary process, the USFP's defection had the opposite effect, forcing a government retreat on at least some USFP proposals, after it realized that in the face of a united opposition, without the USFP the budget might have gone down to defeat. End Summary.

¶2. (SBU) The broad spending plans of the government were not contested in parliament, although they are based on an optimistic economic forecast (6.8 percent growth, 2 percent inflation, and oil at 75 dollars a barrel) and forsee an increase in the budget deficit from 1.9 percent of GDP to 3 percent. The government's tax plans sparked a firestorm of controversy, however. Both the opposition Justice and Development Party (PJD) and socialist USFP Party slammed the government's decision to grant general relief by reducing the rate on companies from 35 to 30 percent, and by reducing the rate on banks and financial institutions over two years to 35 percent from 39.6 percent. PJD Deputy Secretary General and chief economist Lahcen Daoudi described the measure to us as an unwarranted "gift" to a sector that is already doing very well, and insisted that any change should instead be targeted on small and medium sized enterprises, who are most in need of tax relief. USFP deputies echoed this critique, and were not moved by Minister of Economy and Finance Mezouar's arguments that SMEs would be the principle beneficiaries and that the change was needed to compete with the lower corporate tax rates in such competitors as Tunisia and Turkey. USFP Deputy Khalid Hariri (the party's chief economist and Vice Chair of parliament's Finance Committee) told us 90 percent of the corporate tax benefit would have gone to the largest 100 corporations in Morocco. He added

that his party remains convinced that income tax relief would do more for the competitiveness of Moroccan companies than would reduction of the corporate tax.

¶3. (SBU) The government ultimately invoked article 51 of the constitution to rule most opposition amendments out of order in the finance committee, but in the face of continued USFP recalcitrance it was forced to extend an olive branch to its coalition partner, as it faced the prospect that it would not secure the votes necessary to pass the overall budget. After emergency consultations last week before the November 30 plenary debate, the government ultimately agreed to limit the corporate tax reduction on banks to 37 percent (abandoning next year's second cut) and to "engage" formally to review income tax rates in the 2009 budget. With these concessions, the USFP ultimately joined its coalition partners in approving the draft. In a sign of how the USFP's stand animated the debate, however, more than 250 deputies attended the start of the plenary budget session on Friday November 30, more than three times the number that attended the session the year before.

¶4. (U) Reduction in the corporate tax is not the only significant fiscal measure introduced in the budget, however, and there is a strong possibility that the government will be forced to make further concessions in the upper house when that chamber takes up the budget this week. Particularly controversial in the north is a proposal to eliminate the tax advantages that the Tangier region has enjoyed since 1963. Since that time, companies in Tangier have benefited from a 50 percent reduction in corporate tax, which can be compounded by other tax advantages. Hence exporters in the north face an 8.25 percent tax rate (half of half of the corporate tax rate). Critics argue that the region needs no such special benefits, given the extensive investment in infrastructure and other projects that has occurred there in recent years. Arguments in favor of equal treatment prevailed in the lower chamber, but regional representatives are likely to puruse their interests in the upper house, arguing that the north's economic take-off is still fragile, and the change would seriously damage the area's attractiveness to investors.

¶5. (C) Also controversial are plans to re-establish a 20 percent tax on capital gains (the rate is currently 10 percent). The brokerage industry is mobilizing to fight the change and one brokerage has even taken out full page ads suggesting that the government maintain the current lower rate for short term speculators, while imposing the higher tax on those who hold their assets over the long term. It argues that the first group could be discouraged by the higher rate in its efforts to turn a "quick profit." Given that such short term positions make up 40 percent of the volume of market transactions, it argues any such "discouragement" could have a serious impact on the market as a whole. Hariri told us wryly that the lower chamber dismissed the brokerage proposal, given that short term speculators do little to promote savings and investment, and that maintaining stock market volume is not a "national interest."

¶6. (U) A final point of controversy surrounded the budget's elimination of the fiscal exoneration that developers of "social housing" have enjoyed. Instead, they will be subject to a 15 percent corporate tax on their profits in 2008 and the full 30 percent tax in 2009. Though the measure has been criticized, most market analysts forsee only limited impact, given thriving market demand. The government has also maintained the tax exemption for a new low-cost housing product (priced at 140,000 MAD or 18,000 USD), provided developers construct sufficent properties in both rural and urban areas.

¶7. (U) More generally, opposition critics have also focused on the optimistic assumptions that underpin the budget,

including particularly the 6.8 percent growth forecast. Finance Minister Mezouar resolutely defended the prediction, pointing out that Morocco has averaged 5 percent growth over the last five years, even when confronted with two years of drought. With an "average" harvest, he insists, growth cannot be below 6 percent. Relatively little attention has been paid to the budget's expenditure side, which underlines the government's social focus by increasing spending on social programs 17.5 percent to 79.5 billion MAD (10.3 billion USD), nearly half of the government's planned non-debt expenditures. Spending for security increases even more dramatically, up nearly 30 percent to 45.6 billion MAD (5.9 billion USD). Together the two areas account for nearly 80 percent of non-debt expenditure. Overall spending increases at a 13.5 percent rate, while receipts are projected to rise 17.5 percent.

¶8. (U) Much of this spending, however, is for regular government operations. The wage bill remains a heavy burden, restrained but not resolved by the voluntary departure program that the government carried out in cooperation with the World Bank. With plans to recruit 16,000 new civil servants (up from the 6,000 added in 2007), spending on personnel will increase 6.7 percent to 67 billion MAD in 2008 and together with related retirement and medical insurance costs (which total 12.5 billion MAD) will continue to absorb nearly half of non-debt government spending. Also slated to increase dramatically in 2008 are expenditures for subsidies on the price of basic goods including bread, wheat, sugar, and fuel (up more than 50 percent to 21 billion MAD) and spending on investment, which will rise 39 percent to 36 billion MAD. The latter figure is only a third of the government's overall investment budget, with the remainder coming from investments by state enterprises and support from the Hassan II investment fund. Critics note, however, that often these investment plans are only partially realized.

¶9. (C) Comment: Passage of the 2008 budget has been a trial by fire for the new government and particularly Minister of Finance Mezouar. As much as substance, the maneuverings seem to have been used by all parties to position themselves in the face of what is widely perceived to be a weak and inchoate government. The USFP in particular sought to demarcate itself from its partners, in the face of continued discontent in its rank and file over its poor showing on September 7 and over its subsequent decision to participate in the government.

¶10. (C) Comment continued: Finance Minister Mezouar has remained determined in the face of the storm, however, and his concessions to date to the USFP appear as much to track with his own long-term plans for tax reform as to represent a climbdown by the government. While the current budget is largely the work of his predecessor, and was only modified on the margins, Mezouar has large ambitions, as reflected in the

number of tax reforms the draft contains. He plans to go further: during a November courtesy call by the Ambassador, he conceded that income tax is very sensitive and cannot be changed immediately, but he insisted it will ultimately require a "change in structure." Similarly, he outlined plans to further reduce the corporate tax and value added tax. These are laudable ambitions which would help reduce Morocco's informal economy, but they remain challenging when the underlying budget deficit remains in the range of 3 percent of GDP and privatization revenues are no longer available to help cover the gap. End Comment.

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